Medway Council
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AUDIT COMMITTEE

30 JUNE 2016

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

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Summary

This report gives an overview of treasury management activity during 2015/16

1 Budget and Policy Framework

1.1 The council's treasury management strategy and policy are approved by Full Council following consideration by Cabinet and Audit Committee.

2 Background

2.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators for 2015/16. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

2.2 During 2015/16 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 26 February 2015)
- A mid-year treasury update report (Council 15 October 2015)
- An annual report following the year describing the activity compared to the strategy (this report).

2.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

2.4 This Council also promotes prior scrutiny of the Treasury Strategy and mid-year review by submission to Audit Committee before reporting to Cabinet and Full Council.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2016;
- Borrowing activity 2015/16
- Performance measurement
- The strategy for 2015/16
- The economy and interest rates in 2015/16
- Borrowing rates in 2015/16
- The borrowing outturn for 2015/16
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2015/16
- Investment outturn for 2015/16

3 The Economy and Interest Rates

3.1 Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

3.2 These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in the UK surged strongly during both 2013/14 and 2014/15 to make the UK the top performing advanced economy in 2014. However, 2015 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

3.3 The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling materially. These rates continued at very low levels during 2015/16.

3.4 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

3.5 The ECB had announced in January 2015 that it would undertake a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015. The anti-austerity government in Greece, elected in January 2015 eventually agreed to implement an acceptable programme of cuts to meet EU demands after causing major fears of a breakup of the Eurozone. Nevertheless, there are continuing concerns that a Greek exit has only been delayed.

3.6 As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

3.7 On the international scene, concerns have increased about the slowing of the Chinese economy and also its potential vulnerability to both the bursting of a property bubble and major exposure of its banking system to bad debts. The Japanese economy has also suffered disappointing growth in this financial year despite a huge programme of quantitative easing, while two of the major emerging market economies, Russia and Brazil, are in recession. The situations in Ukraine, and in the Middle East with ISIS, have also contributed to volatility.

3.8 The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

4 Overall Treasury Position as at 31 March 2016

4.1 The Council's debt and investment position at the beginning and end of the year was as follows.

Table 1 – borrowing and investment levels

	31/03/15 £m	Rate	31/03/16 £m	Rate
Long Term Borrowing – PWLB/LOBO	164.0	4.22%	164.0	4.22%
Long Term Borrowing – Growing Places/Salix	0.7		7.5	
Short Term Borrowing	1.3		9.3	0.752%
Plus Other Long Term Liabilities*	0.8		0.5	
Total Debt	166.8		181.3	
Capital Financing Requirement (CFR)	247.8		252.0	
(Under)/Over Borrowing	(81.0)		(70.7)	
Less investments	31.9	1.51%	22.5	1.13**%
Net borrowing	134.9		158.8	

* Embedded Leases (on balance sheet)
** The rate obtained for investments to 31 March 2016 excluded dividends on CCLA Property Fund.

5 The Strategy for 2015/16

5.1 The expectation for interest rates within the treasury management strategy for 2015/16 anticipated low but rising Bank Rate, (starting in quarter 1 of 2016), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

5.2 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

5.3 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back.

6 The Borrowing Requirement and Debt

6.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2015/16 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

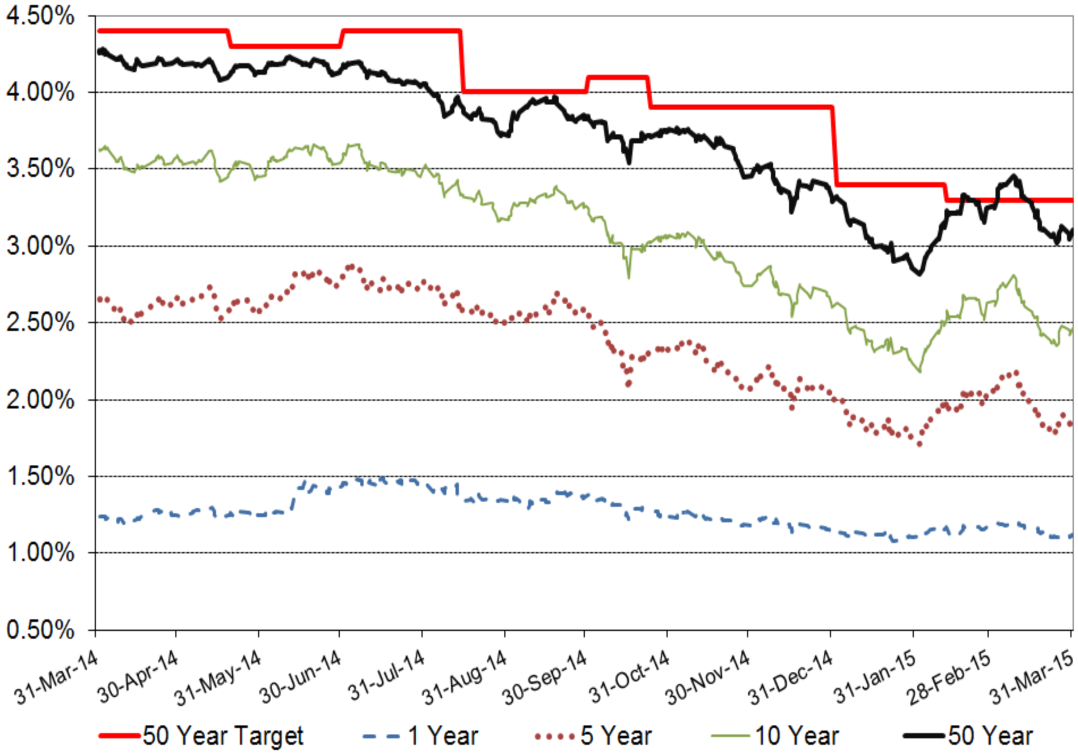
Table 2 Capital Financing Requirement

	31 March 2015 Actual £000	31 March 2016 Budget £000	31 March 2016 Actual £000
CFR General Fund (£m)	207,269	203,124	211,399
CFR HRA (£m)	40,542	42,524	40,566
Total CFR	247,838	245,648	251,965

7 Borrowing rates in 2014/15

7.1 PWLB borrowing rates - the graph below shows how PWLB rates remained at historically very low levels during the year.

PWLB certainty maturity borrowing rates.



8 Borrowing Outturn for 2015/16

8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO. This type of borrowing has therefore been classed as fixed rate.

8.2 No new long term loans were taken out and no repayments of long term loans made except for annuity repayments.

8.3 The approach during the year was to use cash balances to finance new capital expenditure so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.

8.4 Expenditure levels at the end of March 2106 necessitated the undertaking of temporary borrowing from other councils. Details of the borrowing is shown in the table below

Lender	Amount Borrowed	Date Borrowed	Date Repaid	Annual Interest Rate
Bridgend County Borough Council	£2m	31/3/16	29/4/16	0.55%
Erwash Borough Council	£1m	31/3/16	15/4/16	0.5%
Cheshire West & Chester Council	£5m	31/3/16	29/4/16	0.55%

8.5 Largely as a result of government rescheduling of grant payments Medway has less liquid cash during 2016/17. Liquidity is being managed through continued use of temporary borrowing rather than taking out longer term borrowing higher rates. The new loans borrowed to date in 2016/17 are as follows

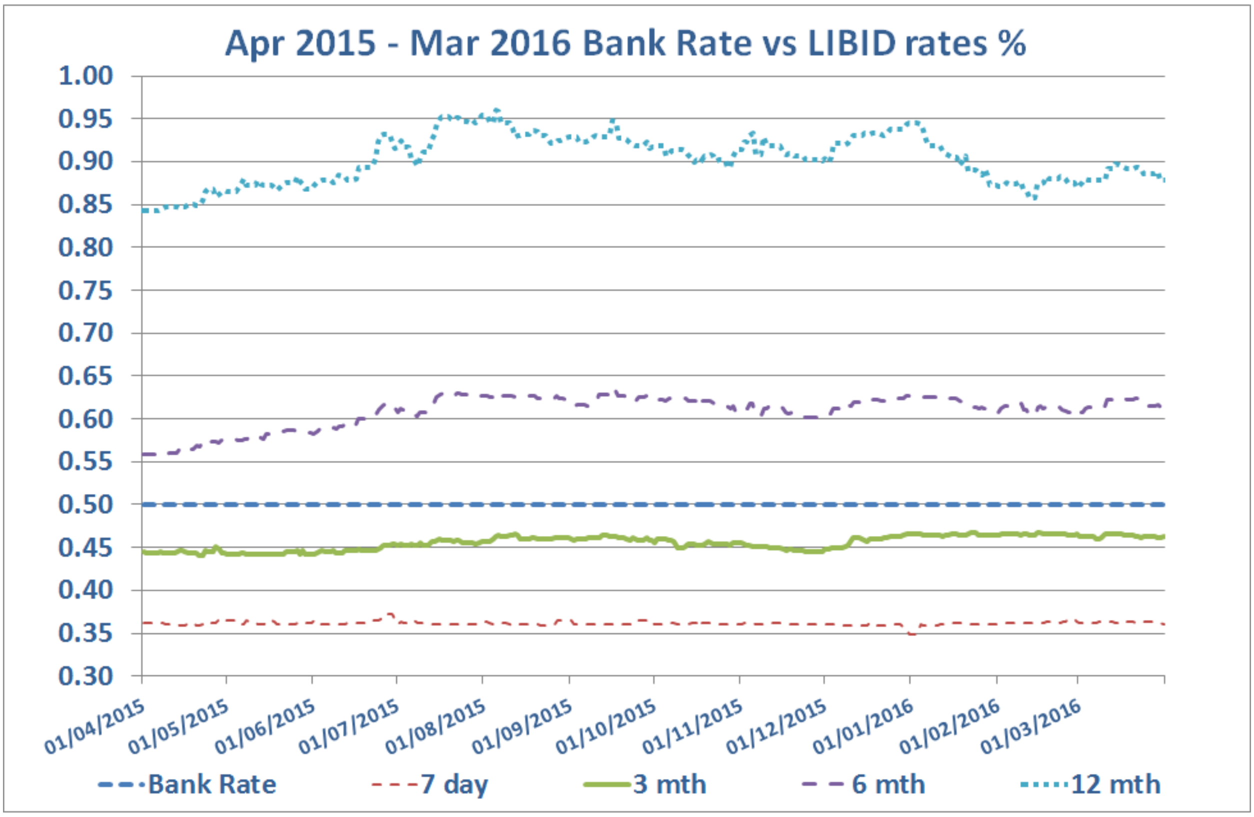
Lender	Amount Borrowed	Date Borrowed	Repayment Date	Annual Interest Rate
Leicester City Council	£3m	1/4/16	14/4/16	0.5%
West Yorkshire Combined Authority	£2m	11/4/16	22/4/16	0.35%
Greater Manchester pension Fund	£20m	26/4/16	19/7/16	0.5%

9 Debt Rescheduling

9.1 No debt restructuring was undertaken during 2015/16 as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable. It is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2016/17.

10 Investment Rates in 2015/16

10.1 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme and due to the continuing weak expectations as to when Bank Rate would start rising.



11 Investment Outturn for 2015/2016

11.1 **Investment Policy** – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 26 February 2015. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

11.2 **Internally Managed Investments** – The Council manages its investments in-house using the institutions listed in the Council's approved lending list. These funds are identified as 'core funds' where the investment can be for an extended time period and usually fixed prepayment date, or 'cash flow' where the investment is required to be available for immediate liquidity. The council can invest for a range of periods from overnight to 5 years dependent on forecast of the Council's cash flows, the duration and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council's treasury management policies and practices. The Annual Investment Strategy, outlines the Council's investment priorities as:

(1) Security of capital and liquidity; and
(2) The achievement of optimum return (yield) on investments.

11.3 **Externally Managed Investments** – The Council invested £3m in the Churches Charities & Local Authorities (CCLA) Property Fund.

11.4 **Investment performance for 2014/15 –** Detailed below is the result of the investment strategy undertaken by the Council.

Table 3 Internally Managed Investment Performance 2015/16

	Average Investment	Rate of Return (gross of fees)
Internally Managed – Core Funds	£19,475,000	2.06%
Internally Managed – Cash Flow Funds	£33,536,905	0.79%
Overall Internally Managed Funds (excluding CCLA)	£53,033,906	1.13%

11.5 Core funds were invested with other local authorities as follows

Authority	£m	Maturity Date	Rate%
City of Newcastle Upon Tyne	5.00	31/7/19	2.35
Lancashire County	5.00	1/8/18	2.00
Doncaster Metropolitan Borough	5.00	8/8/19	2.35
Newcastle City	4.75	10/7/17	1.50
	19.75		

11.6 In addition £3m was invested in the CCLA Property Fund on 31 October 2015 and yielded £52,806 dividends net of expenses in the five month to 31 March 2016, equivalent to an annualised return of 4.22%. The capital value that the holding could have been sold for on 31 March was £2.823m with the fall in value being less than the difference between the offer and bid values on that day. The purchase price for an equivalent holding on 31 March 2016 was £3.061m.

11.7 No institutions in which investments were made during 2015/2016 had any difficulty in repaying investments and interest in full during the year.

11.8 The graph below is produced by Capita Asset Services (our external adviser) in its own benchmarking exercises which are built to compare return vs. risk.

11.9 The “x” axis of the graph shows the “Model Weighted Average Rate of Return” (WARoR), this is the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the “Actual Weighted Average Rate of Return” on the “y” scale. Running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above indicates that the return being received is above expectation. As can be seen Medway’s return is “above” that expected for our level of risk.

11.10 The Capita benchmarking is run as a snap shot as at 31 March 2016 and not the performance for the whole of 2015-16 financial year.

Actual Returns against Model Returns

	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Medway Council	1.95%	1.50%	0.46%	1.44%	1.55%	Above

12 Compliance with Treasury Limits

12.1 There were no breaches of treasury limits in 2015/16. The outturn for the Prudential Indicators is shown in Appendix 1.

13 Risk Management

13.1 Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

14 Financial and Legal Implications

14.1 Overall the Interest and Financing budget made a surplus over its targeted budget of £3.455m. In light of the continued historically low bank rate which continued at 0.5% throughout 2015/16, the overall rate achieved on cash based investments averaged 1.13%. Interest payments were lower than budgeted as planned PWLB borrowing was not executed. The saving on MRP was due to the revision in methodology agreed by Council in October 2015.

14.2 A breakdown of the Interest and Financing budget is shown below

Table 4 Interest and Finance Budget against spend

	Budget 2015/16 £000's	Actual 2015/16 £'000s	(Under)/ Overspend £'000s
Treasury Expenses	172	548	376
Interest Earned	(2,938)	(3,155)	(218)
Interest Paid	9,047	8,808	(239)
KCC Principal	1,603	1,603	0
MRP	5,905	2,821	(3,083)
Invest to Save recharges	(544)	(836)	(292)
Total	**13,245**	**9,789**	**(3,456)**

14.3 £342,000 of the adverse variance on treasury expenses was caused by a payment to HMRC in respect of output VAT on charges to HM Prisons. The payment arose from an error by Medway Council in failing to recognise the need to charge VAT. Other authorities have made similar errors when charging outside organisations for staff. A review of processes has been commissioned from our VAT advisors to ensure that similar errors do not occur.

14.4 The body of the report and the appendices outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.

14.5 Legal implications – For the financial year 2015/165 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

15 Recommendations

15.1 In accordance with the CIPFA Code of Practice, Audit Committee is asked to note the content and recommend this report to Cabinet

Appendices
Appendix 1 Prudential Indicators

Background papers
None

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Appendix 1

PRUDENTIAL AND TREASURY INDICATORS

	2014/15	2015/16	2015/16
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	35,675	22,966	35,312
HRA	5,437	8,071	6,784
TOTAL	41,112	31,037	42,096
Ratio of financing costs to net revenue stream			
Non - HRA	4.52%	2.92	4.08%
HRA	22.73%	17.66	23.18%
Gross borrowing requirement			
brought forward 1 April	166,132	164,103	166,006
carried forward 31 March	166,006	168,103	180,797
in year borrowing requirement	-126	4,000	14,791
Actual External Debt	166,835	168,103	181,294
Capital Financing Requirement as at 31 March			
Non – HRA	207,296	199,484	211,399
HRA	40,542	42,530	40,566
TOTAL	247,838	242,014	251,965
HRA Limit on Indebtedness	45,846	45,846	45,846
Annual change in Cap. Financing Requirement			
Non – HRA	-1,725	9,873	4,103
HRA	1,026	3,014	24
TOTAL	-699	6,859	4,127

	2014/15 Limit £'000	2015/16 Limit £'000	2015/16 Breach?
Authorised Limit for external debt -			
borrowing	424,282	420,285	No Breach
other long term liabilities	4,400	4,400	No Breach
TOTAL	428,682	424,685	No Breach
Operational Boundary for external debt -			
borrowing	385,711	382,077	No Breach
other long term liabilities	4,000	4,000	No Breach
TOTAL	389,711	386,077	No Breach
HRA Limit on Debt	45,846	45,846	No Breach
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	No Breach
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	No Breach
Upper limit for total principal sums invested for over 364 days	£150,000	£150,000	No Breach
(per maturity date)			

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit	Breach?
under 12 months	75%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	0%	No Breach